CYCLES RESEARCH EARLY WARNING SERVICE

by Bill Meridian

Summary

This service is moving to a sell signal on the stock market at the close on August 29. Cycles Research moved to a buy on gold as of Friday's close on May 29. A buy was issued on bonds as of the close on Monday, July 1.

Analysis

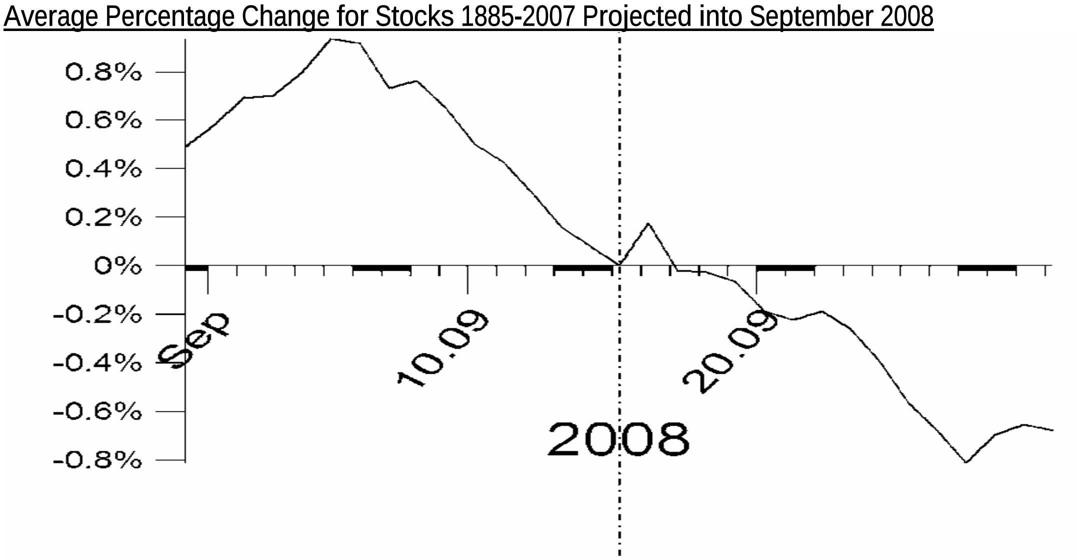
There are several reasons to move to a sell signal on US stocks at this time:

- The composite CATS indicator gave a sell on the close on Friday
- September has traditionally been the weakest month of the year
- Two cycles have turned down as mentioned in the last report
- Sentiment appeared too bullish late in this past week.

The CATS barometer measures market momentum and is useful in trading markets but it less useful in bull markets. The sell signals in 2008 were on January 4th, February 29th, May 9th, and on August 29th. Three of those sell signals preceded declines.

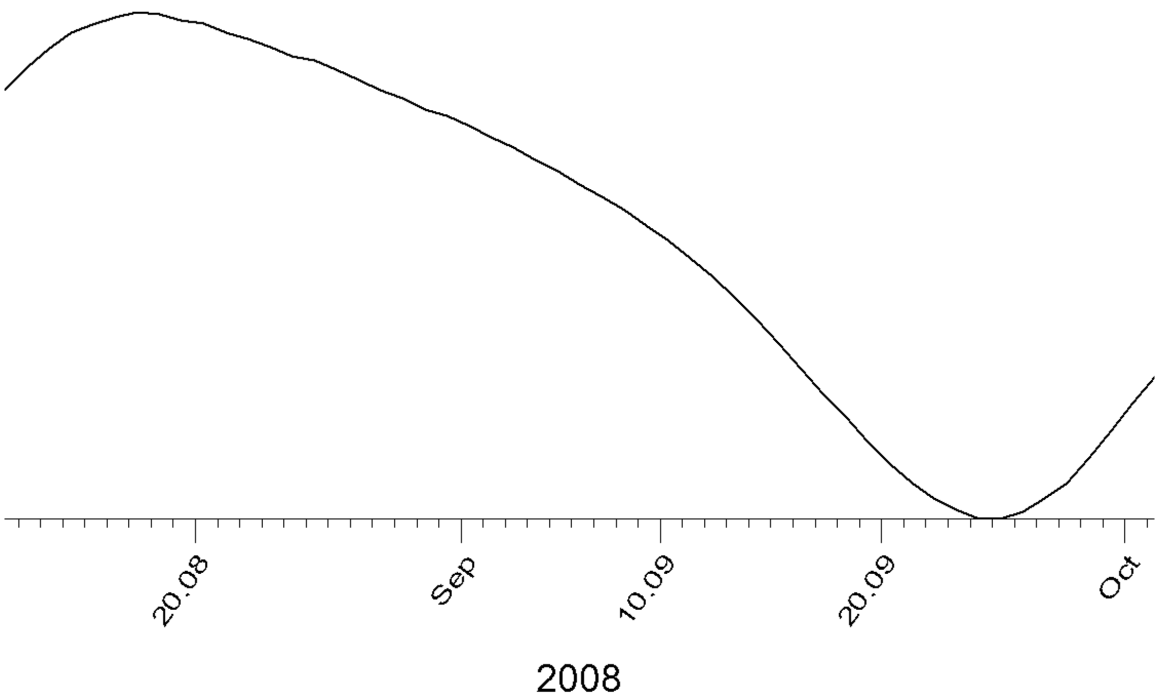
September has not been down since 2003, but it has traditionally been the weakest month in any year. In election years, this month has been down 60% of the time for an average drop of almost 2%. The graph below depicts the average behavior of the Dow in the month of September from 1885 to the present. On average, the top has been on the 5th of September and the low has been on the 27th. The market has fallen almost 60% of the time between those 2 dates. It is important to keep in mind that these readings have been taken through both bull and bear markets, so the declines are worse in bear markets. Over the past decade, the top in a declining September has shortened up to the 3rd of the month.

Average Percentage Change for Stocks 1885-2007 Projected into September 2008



Few realize that the annual cycle is the solar cycle. The annual cycle is based upon the calendar, and the calendar is based upon the relationship between the earth and the Sun. If the annual or solar cycle is reliable, then why not employ other cycles derived in a similar manner? The Mars-Uranus cycle is 1.9 years in length and it topped last month. The Mars sidereal cycle is 1.9 years in length, and it also hit its peak last month. Had one bought and sold the Dow from 1885 to the present, one would have outperformed a buy-and-hold strategy by almost 8 to 1. With these 2 cycles in their declining phases in addition to the descending annual cycle, the odds are that stocks will move lower. The sum of this trio of cycles is depicted below.

Three-Cycle Stock Market Composite

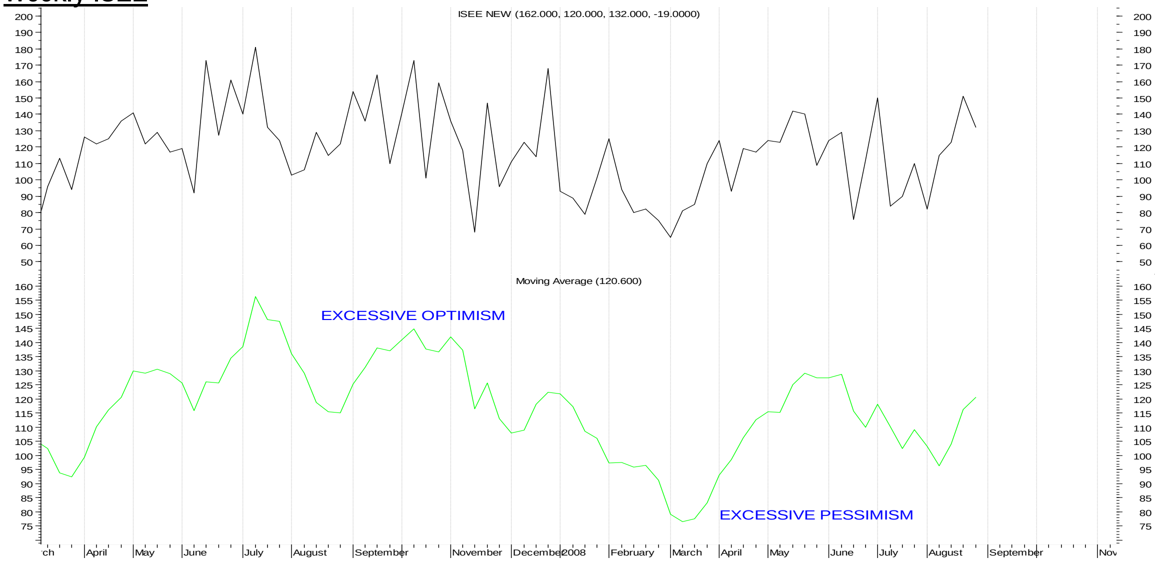


Sentiment can be measured in several ways. The ISE sentiment numbers can be downloaded from ise.com. The index is describer there as:

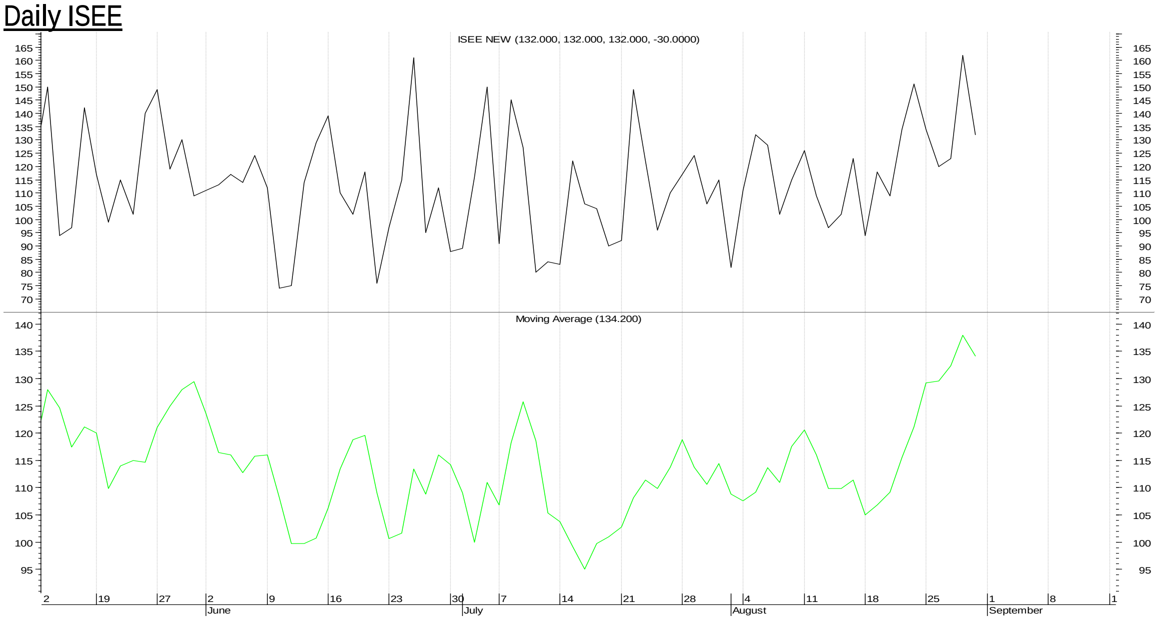
"The ISE Sentiment Index is a unique put/call value that only uses opening long customer transactions to calculate bullish/bearish market direction. Opening long transactions are thought to best represent market sentiment because investors often buy call and put options to express their actual market view of a particular stock. Market maker and firm trades, which are excluded, are not considered representative of true market sentiment due to their specialized nature. As such, the ISEE calculation method allows for a more accurate measure of true investor sentiment than traditional put/call ratios."

Thus, high numbers are bearish, and low numbers are bullish as marked on the weekly graph. Note the excessive optimism at the October and May highs. Below that graph is the daily version. We can see how it spiked up on Thursday as the market rallied, but hardly retreated on Friday's weak close. I think that this reflects too much optimism going into September.

Weekly ISEE



Daily ISEE



And lastly, there is market activity. There have been eight 300-point DJIA rallies since July 2007, and during the 2000-2002 bear market there were sixteen 300-point DJIA rallies. During the 2003 to 2007 bull market there were no 300-point DJIA rallies. Lowry's concludes that August's 300-points DJIA rallies were bear market rallies. Volume in the month of August is down about 25% from the prior month, on average. However, it fell by as much as 60% into this August, a sign of little buying interest. New lows have generally exceeded new highs.

And, with the S&P now down 20% from the October high, the market has now met the accepted definition of a bear market. Thus, I expect most questions to be answered on the downside. First legs in bear markets range in length from 30 to 34 months. This measure is determined by adding together the bear markets in the Nikkei from 1989, gold from 1980, and US stocks from 1929 and then dividing by three. It was this yardstick that I employed in the spring of 2000 to project an October 2002 bottom. Measuring from the October high suggests a low in the spring or summer of 2010.

And, once again, there is another similarity between the current era and the 1970s. The July 15^{th} low was predicted (to the day) by Joe Granville.

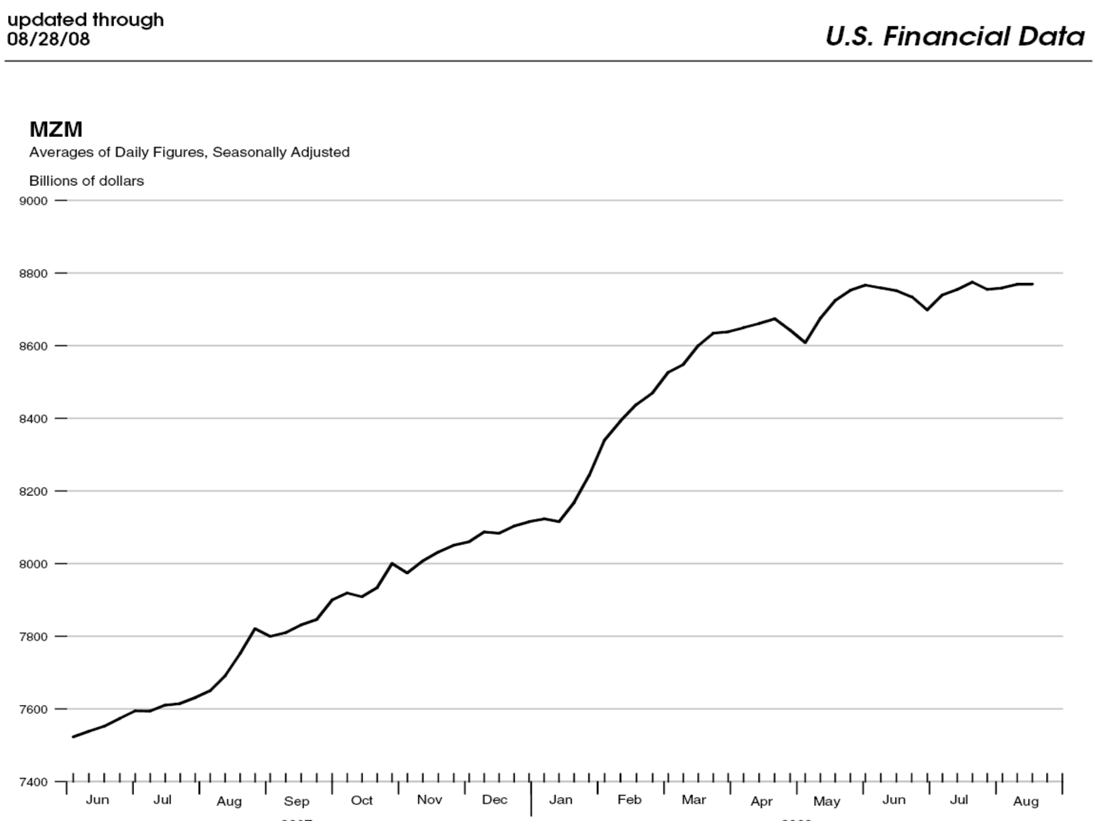
Turning Point Analysis

The strongest turning point is September 5^{th}. Although the market began falling on Friday, my best guess is that the 5^{th} is a high. There is a turning point on Thursday, the 18^{th}, the day prior to the third Friday of the month, option expiration. There is a bullish bias into option expiration in each month. The week after option expiration in the month of September have a very bearish bias. The low for the month is likely on the 24^{th} or 25^{th}.

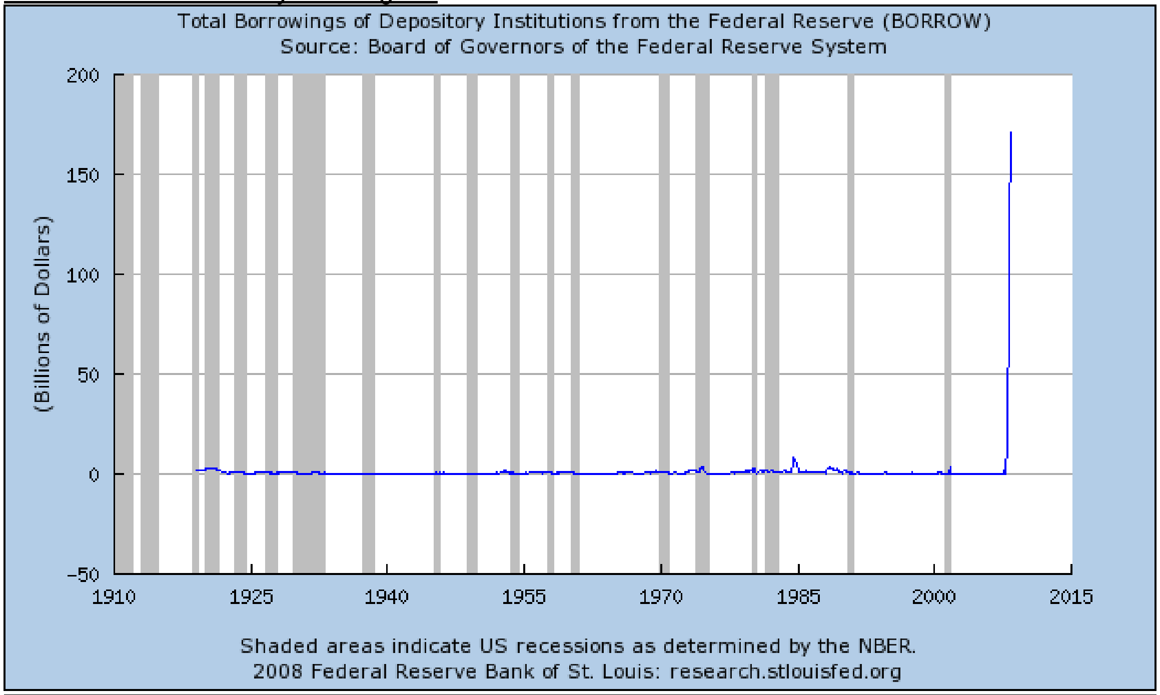
Where Has All the Liquidity Gone?

The money supply has been rising, albeit at a slower pace. If the money supply has been increasing, why have not all markets been rising? The second graph is that of borrowings at the Fed window. Note that the blue line was flat as a pancake until recently. It has shot straight up, telling us that most of the funds are likely simply being used to keep institutions afloat.

Here is Where the Money is Coming From:



Here is Where the Money is Going To:



Bonds

I picked this bond news up from Bloomberg.com on Friday. I was uncertain as to where to place it; I thought that bond traders would be most interested:

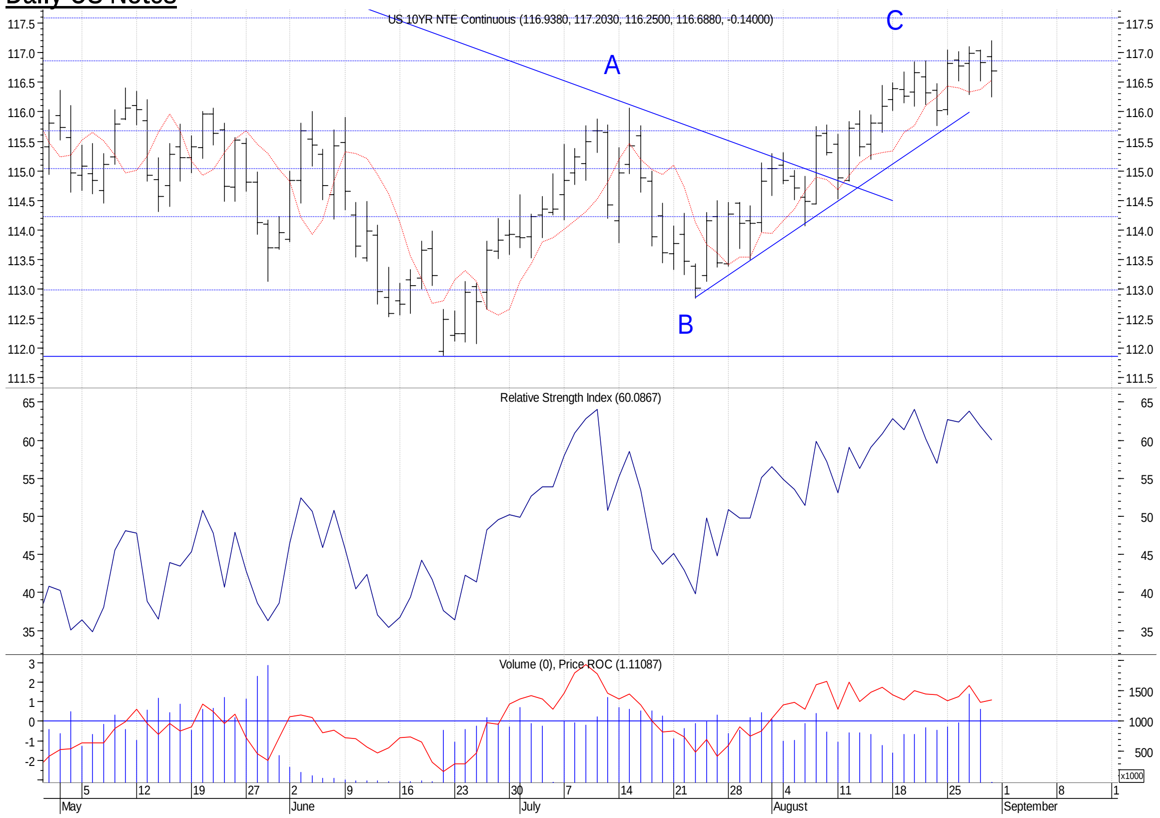
"Iraq's bonds are delivering the biggest returns in emerging markets as oil export revenue bolsters government finances and violence declines. The country's $2.7 billion of 5.8 percent bonds due 2028 gained 45 percent since August 2007, according to Merrill Lynch & Co. indexes. Investors demand 4.84 percentage points more in yield to own the debt instead of Treasuries, down from 7.26 percentage points a year ago. The spread is narrower than for notes of Ohio banks National City Corp. and KeyCorp, suggesting Baghdad may be safer for bond investors than Cleveland."

The most bullish part of the annual cycle is from August 7th to August 21st. Chart 1 below shows that notes have been tracing out an A-B-C pattern to the upside and made an outside day on the last close. In addition, notes are overbought. Wave A= 4.187 and wave C= 4.36. Thus, the two are close to unity, a typical relationship. In addition, the current price is very close to a 50% retracement of the prior decline as depicted in the weekly graph. Whereas this is not a sell signal, it is an indication that the current rally is mature.

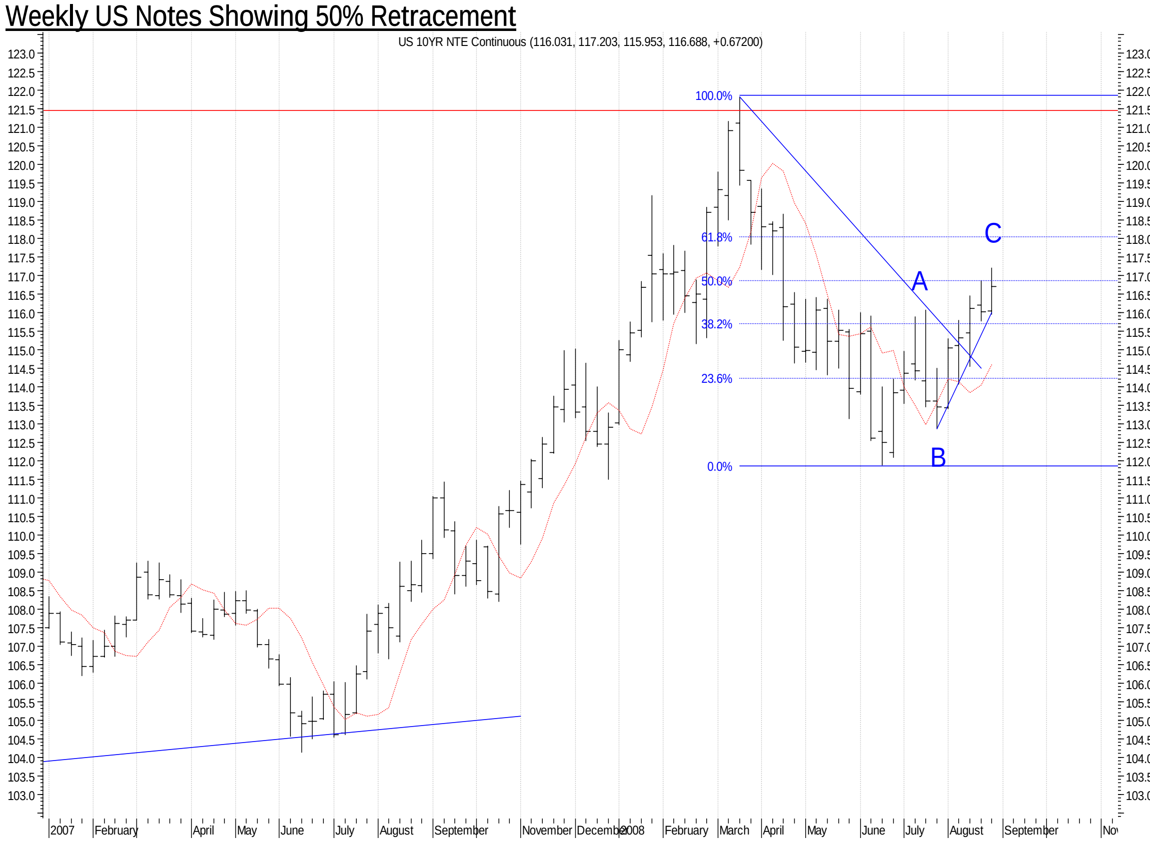
Notes are not overbought weekly or monthly, and major changes in direction have historically not occurred at this time of the year. In addition, sentiment does not appear to be at an extreme at this time. Thus, this is unlikely to be a major high.

The 5-cycle composite of t-note prices tops on September 9. In addition, research has demonstrated that there is a 78-day cycle in bond prices. September 6 is 78 days from the June 20 low. Thus, notes are likely to turn down between the 6th and the 9th. These dates include a weekend, so the Friday the 5th may mark the beginning of a more concerted pullback. I may switch to a sell signal on that date.

Daily US Notes



Weekly US Notes Showing 50% Retracement

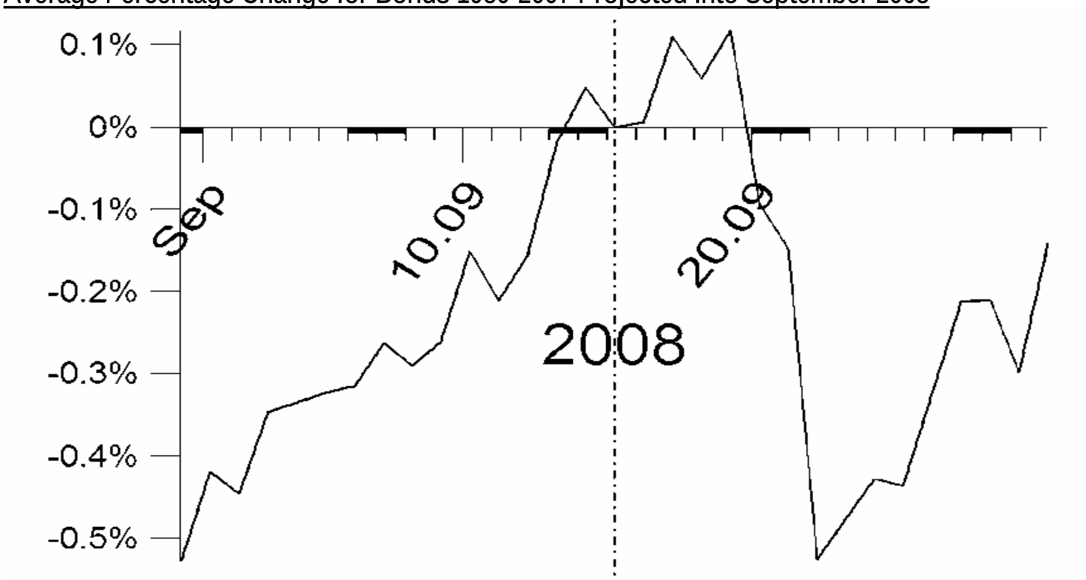


I do not think that bonds have very far to fall. The situation reminds me of the old Woody Allen story (back in the days when he was humorous) of his uncle who lost his money in the stock market crash in 1929 and tried to take his life by jumping out of the window, but he lived in the basement. So he jumped up onto street level. That is, bonds do not appear to have much room to fall for the following reasons:

- Bonds are not overbought weekly or monthly
- Sentiment is too bearish. The bond put/call indicator shows the highest readings since June of 2008
- Seasonally, bonds are typically strong in the second half of any calendar year
- Getting out the seasonality microscope, we see below that September has not been a weak month traditionally.

Bonds have risen from the 1st to September 19th about 73% of the time. From the 19th to the 22nd, bonds have fallen 81% of the time.

Average Percentage Change for Bonds 1980-2007 Projected into September 2008



The message is that the rally from June 20 is likely to end or to simply lose its impetus, resulting in either a correction or simply in a more desultory, sideways movement. Bond holders and traders with a short-term orientation may wish to take some profits.

Sectors and Groups

Seasonally, we have entered the weakest 2-month stretch (August 25th-October 27th) for technology, so the breakdown by Dell on Friday likely begins a decline for the IT sector. Based upon other cycles, I think that October-November is going to be a very weak period for technology stocks. Thus, I doubt that we will see the usual seasonal strength from late October. Portfolio managers may want to lighten holdings in this sector now.

Here is the sector performance thus far in 2008:

SECTOR	2008 % CHANGE
Consumer Staples	-2.4
Energy	-5.7
Materials	-5.8
Health Care	-6.6
Consumer Discretionary	-8.9
IT	-11.4
Utilities	-11.7
Industrials	-12.7
S&P	-13.0
Communications	-23.7
Financials	-31.5

Energy

Oil is in a seasonally strong period from July 25th to October 17th. With Support is at $100 and at $107 underneath, I do not think that oil will break down now. Seasonally, most highs are in the month of October. Since July 15th, the stocks have actually been stronger than the commodity.

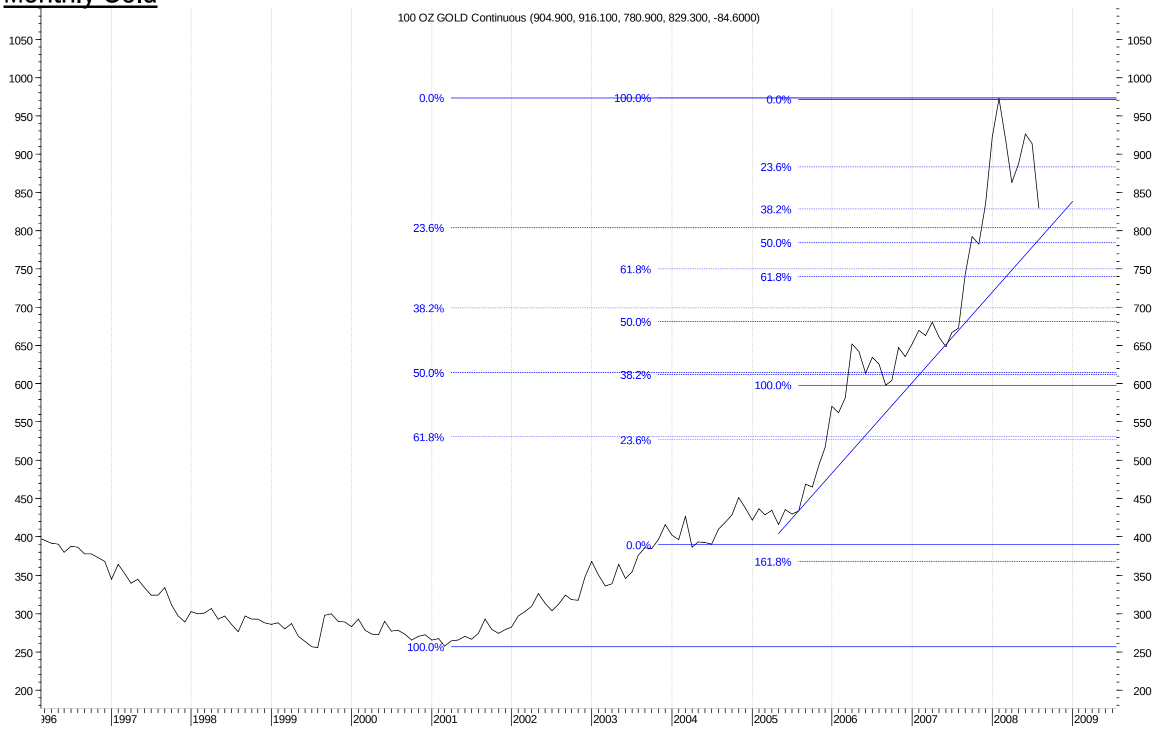
Weekly Oil Price

House Democrats Call for Nationalization of Refineries Rep. Maurice Hinchey (D-NY), member of the House Appropriations Committee and one of the most-ardent opponents of offshore drilling: “We should own the refineries. Then we can control how much gets out into the market.” This is what high oil prices have been discounting, the actions and ideas that restrict supply.

Gold

The metal bounced off of support. The monthly graph below shows a support line at 800 in addition to several retracement lines. Gold is oversold weekly but not monthly. September is historically the most bullish month for gold, so I doubt that bullion will move lower. The period from August to January has historically been the strongest seasonal cycle for the yellow metal.

Monthly Gold



Individual Stocks

ERTS has underperformed but is now at a low. GENZ and VAR have done well, but we may be close to taking profits. GENZ is overbought weekly but not daily or monthly. VAR is overbought both weekly and daily, but is giving buy signals daily, so it may add a few more points after its 20% increase. Both stocks hit a new all-time high in August, exhibiting excellent relative strength.

PORTFOLIO

Stock	Buy Price	Buy Date	Current Price
Electronic Arts-ERTS*	61.12	Nov. 1	48.81
Genzyme-GENZ*	75.01	Oct. 29	78.30
Varian-VAR*	48.41	Oct. 29	63.16
Buy-Gold ETF- GLD	91.4	July 1	87.71

*High cashflow generator

Strategy

Investors reduce holdings.
Traders go short.

What the Media is Not Telling Us

- They call it redenomination. Zimbabwe's central bank dropped ten zeros from the currency. So 10,000,000,000 (ten billion) Zimbabwean dollars is now one Zimbabwean dollar. The official inflation rate is 2.2 million percent a year. Before the "big lop" a 100 billion Zimbabwean dollar had been issued. By the time it hit the streets, the ten billion dollar bill could not quite buy a loaf of bread. Zimbabwe is an economic disaster. Food shortages plague a country that was once an agricultural success story.
- There is an interesting chart of military losses, 1980 through 2006, at this site: (http://www.fas.org/sgp/crs/natsec/RL32492.pdf). The surprising finding was: Clinton years (1993-2000): 14,000 deaths; George Bush years (2001-2006): 7,932 deaths. "If you are surprised when you look at these figures, so was I. These figures mean that the loss from the two latest conflicts in the Middle East are less than the loss of military personnel during Bill Clinton's presidency; when America wasn't even involved in a war!"
- August 27, 2008 from StrategyPage.com: Over the last few months, al Qaeda's internet propaganda department has been virtually destroyed. The most visible evidence of that is the sharp decline in al Qaeda press releases. Last year, there were as many as 200 of these items a month. Over the past few months, this fell over 90 percent. The reason for this sharp drop was the physical capture of the al Qaeda news and production staff, along with their PCs and data files. Over the last few months, several dozen of these specialists were captured or killed, and nearly a terabyte (a thousand gigabytes) of raw video, sound files, documents and software was captured. This put many key terrorist PR operations out of business. This in turn led to fewer cash donations, or volunteers for combat, or suicide missions. Moreover, the sudden collapse of the al Qaeda PR operation caused the Arab media to move towards more coverage of the Iraqi government (which was now distributing more of its own very professional combat videos). The Arab media had also noticed the sharp loss of public support al Qaeda had suffered in the Arab world. All those Moslem civilians al Qaeda killed in their suicide bombing attacks were rather more than even the most anti-Western Arabs could stomach. The seemingly sudden attacks on al Qaeda's media specialists were no accident. U.S. intelligence has been tracking these guys for years. Al Qaeda protected their media people inside Iraq, even while trying to move a lot of the operation outside the country. But the source of new videos had to be inside Iraq, and much of the initial editing and production was done in Iraq as well. Too many of the al Qaeda media people felt obliged to stay in Iraq, and that ultimately cost them their freedom, or their lives. That's because, the surge offensive last year took control of many areas in central Iraq where al Qaeda was able to keep their media, and other, specialists. But American intel was able to monitor where these people were, and when the surge offensive got rolling, the al Qaeda support soon found that there was no place else to run.

Don't Worry-Be Happy

The perfect antidote for the poverty consciousness is the reading of Dr. Julian Simon's The Ultimate Resource. The author largely presents facts about economic growth and abundance, completely dismantling the arguments of Marx and Malthus. In chapter 35, he discusses how our attitudes and beliefs affect our perceptions of surrounding conditions. He begins with conversations with parents and friends about pollution. He was surprised to find that they believed that the current environment was less clean that that in the past, despite the evidence to the contrary including the elimination of many deadly illnesses. Simon quoted a Newsweek column in which the author stated, "The better the economy does, the more we worry that its good behavior won't continue. They reflect a general anxiety about the future as much as a clear picture of what lies ahead. It's a bewildering game; everyone keeps getting good news and looking for the bad." Simon observes that no matter how much conditions improve, our aspiration level increases so that our anxiety level does not decrease. Instead, we focus on ever-smaller actual dangers. For this reason, we fail to enjoy good fortune due to the comparisons we make. Simon advises us to make realistic comparisons. Look at what we have now compared to what we had in the past, rather than what we might have or what others have. I have found Dr. Simon's words to be very true. I frequently find beliefs about the economy and the markets to be at complete variance with the numbers. The bottom line is that we currently live better than most of humanity throughout history.

Quote of the Month:

"There are no real paradoxes in science; the apparent paradoxes are merely nature's polite way of informing us that our understanding is incomplete or erroneous. With respect to the petroleum paradox, the unrecognized assumption on both sides of the debate was an unquestioned belief that life can exist only at the surface of the earth. None could exist within the earth's crust, down to the deepest levels which we can drill."
-Prof. Thomas Gold

Book Reviews

The Commitment of Trader's Bible by Steve Briese, published by Wiley Trading. The CFTC published the Commitment of Traders Report on a weekly basis. If you want to know how to profitably interpret the numbers, this is the book to read. It is clearly written with ample illustrations. I must add that I received a surprise 90-day trial subscription to weekly reports. They reports were most valuable, accurately predicting the recent pullback in the commodity markets.

Turning Points

The highest-probability S&P and DJIA turning points (+ or – 1 day) for the month are
(The stronger turning points are starred:

5* 18

11-12 24

The highest-probability NASDAQ turning points (+ or - 1 day) for the month are
(The stronger turning points are starred*):

5* 19

11-12 26

CFRS Portfolio

The CFRS portfolio declined 2.91% in Q2 versus a fall of 3.23% for the S&P.
Looking at the returns on an annualized basis from January 1, 1996 through June 30, 2008:

S&P Annual Return: 6.0%
Portfolio Annual Return: 22.7%

Disclaimer: The methods utilized have proven profitable in the past but no guarantee can be made of future performance nor is any liability accepted.
See the website at billmeridian.com.

The report is sent on or prior to the open of the first trading day of the new month, unless otherwise stated. If you do contact us by e-mail, kindly give your full name. We cannot query the database by e-mail address. Thank you.

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